DOW THEORY LETTERS INC.

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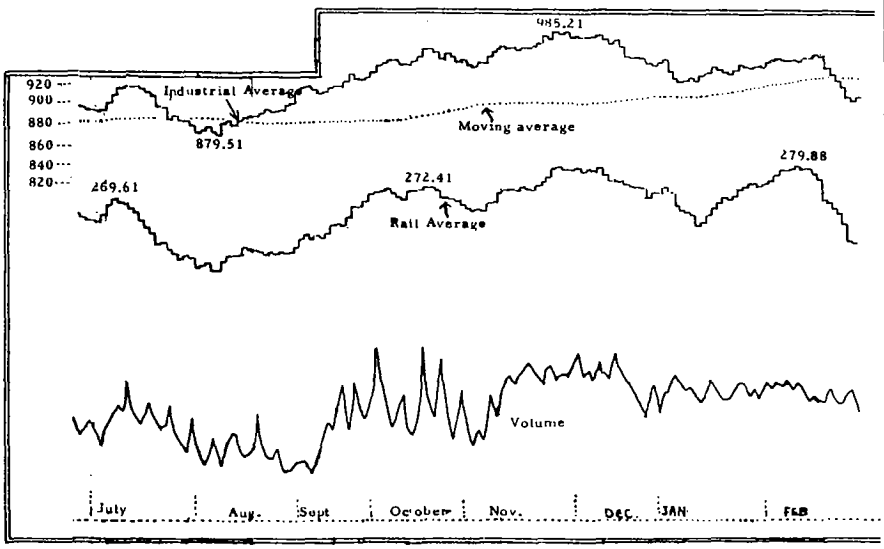
THE MARKET: The week ending February 20 saw a sudden crack in the great 2½ year bear market rally which began in October, 1966. With the Dow Industrials down 35 points for the week and Rails down 12 points, the decline was sweeping and all encompassing. Incredibly, a study of Barron's Group Stock Averages (on the last page of Barron's) shows that for the week ending February 20, every one of the 34 Groups with the single exception of Golds moved into the minus column. The spectacle of all groups declining in a single week is extremely rare; it is symptomatic of broad weakness and should be accepted as a distinct technical warning.

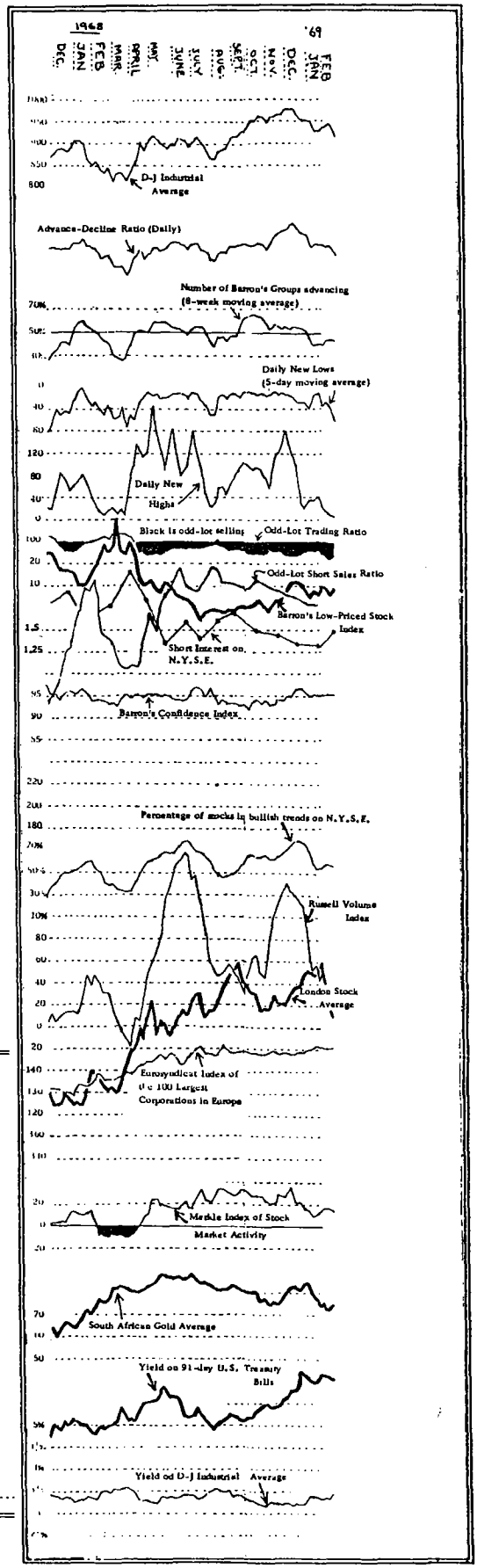
A second warning occurred that same week when the Dow Industrials plunged below their 30-week moving average (see chart), which now stands at 925. This is the first time that the Dow has been below its own moving average since last August. I take it as a distinct signal of danger.

Another sign of a sagging technical structure is the sharp drop of 21 points in Barron's Low Priced Stock Index during the week ending February 20. This is an extremely large drop for this Index, one of the largest on record, and to me it indicates a dramatic revision of price/earnings multiples in the "cats-and-dogs."

February 24 was another "Blue Monday," with the Dow dropping 12 points, thereby sinking well below the area of its moving average. The 900 level, a "fantasy" support zone was cracked on February 25 as the Dow closed at 899.90. On the same day the Rail Average confirmed the decline by breaking sharply under its January 13 low of 260.04 (see chart).

The rupturing of the 900 level was a psychological blow to the bulls, but hardly a significant development. As far as Dow's Theory is concerned, a primary bear market is no respector of support levels, even numbers, or any of a dozen other theoretical considerations so dear to the hearts of market analysts. In fact, bear markets can be characterized by their intensity and their utter disregard of "what the market is supposed to do." The main characteristic of a bear market crash, ironically, is that the market is then




1968
'69
D-J Industrial Average
Advance-Decline Ratio (Daily)
Number of Barron's Groups advancing (8-week moving average)
Daily New Lows (5-day moving average)
Daily New Highs
Odd-Lot Trading Ratio
Odd-Lot Short Sales Ratio
Barron's Low-Priced Stock Index
Short Interest on N.Y.S.E.
Barron's Confidence Index
Percentage of stocks in bullish trends on N.Y.S.E.
Russell Volume Index
London Stock Average
Eurosyndicat Index of the 100 Largest Corporations in Europe
Merkle Index of Stock Market Activity
South African Gold Average
Yield on 91-day U.S. Treasury Bills
Yield on D-J Industrial Average

doing exactly what nobody believes it can do. If they did believe it, they wouldn't be owners of stocks, and Wall Street would already be seeped in the kind of pessimism which precludes a crash.

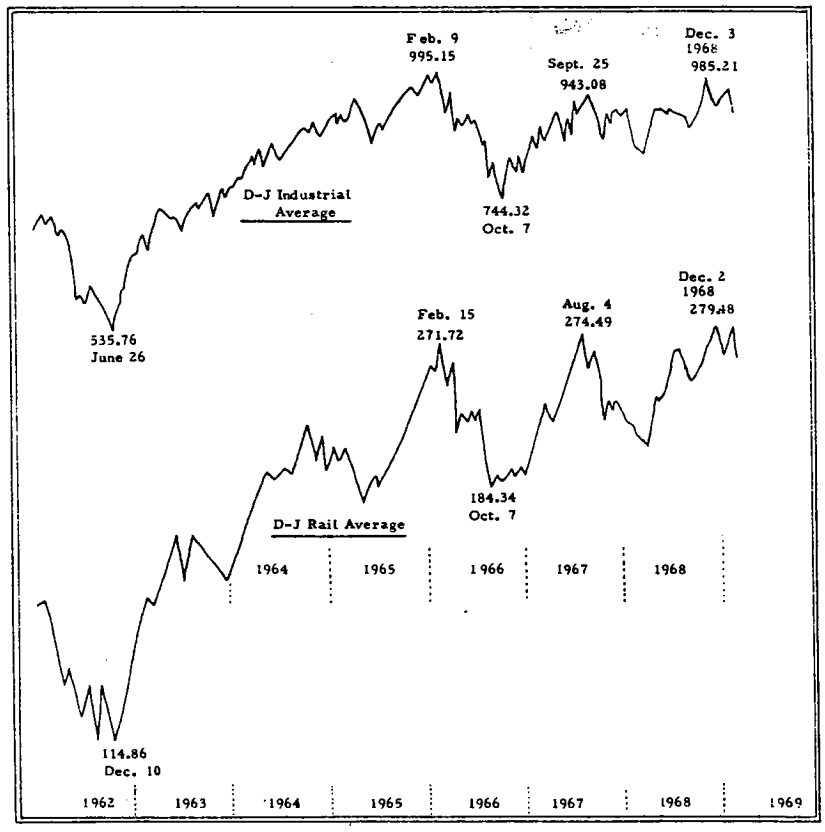
On the world fronts, the news is really no worse than it has been all along. The Vietcong have not yet decided to cooperate with Mr. Nixon, Britain and France are further apart than ever, the franc is nearer devaluation than ever, Israel is bombing the Arabs as she might be expected to do, and Mr. Nixon is calling for talks with the Russians. As I have repeatedly predicted (and as I again predict), if and when Mr. Nixon does talk to the Russians (and DeGaulle may be included in this) the subject of gold will loom large. Both Russia and France want a higher gold price, and this may well be part of the cost of "friendly cooperation."

Meanwhile, the price of gold jumped to $46.35 in Paris a week ago, a new all-time high for the yellow metal. My friend Joe Granville writes about a private ultimatum from DeGaulle to Nixon to the effect that if the price of gold is not boosted by April, France will devalue the franc by 40 to 50%. I do not know the truth of this statement, but I do know what the effect of a huge devaluation of the franc would be. In a word, chaos in world monetary affairs. Is this what the market is discounting?

Personally, I take the decline in the market as a belated return to reality, and a slow recognition of what I have been saying all along, namely, that the forces of inflation and deflation are now meeting head-on. To put it more bluntly, inflation is now gasping its last, and the historically high interest rates and the cessation in the money-supply explosion are acting like pins in the inflation balloon. Wall Street deflates itself first, and the rest of the nation follows, said William Hamilton, the famed Dow Theorist. In view of this, I take with a grain of salt the words of our leaders regarding a gradual, "fine tuned" end to inflation.

Inflation following a boom never ends with a whimper, it ends with a collapse of the speculative edifice. Such a collapse may be happening now or it may possibly be postponed a few months or so. From the standpoint of Dow Theorists, the exact timing makes little difference. Deflation will follow the boom as the night follows the day; it remains only for my subscribers to be prepared (which I sincerely hope they now are).

PERSPECTIVE: I have been talking about the primary bear market since February, 1966, at which time the Dow Jones Industrial and Rail Averages recorded their last joint highs. In his definitive work, "The Story of the Averages," pioneer Dow Theorist Robert Rhea defined the peak of a primary bull market as that point at which the Industrial and Rail Averages record their last joint highs. From the standpoint of the Dow Theory and history, the last joint highs of the bull market which began in 1949 was struck in February, 1966, Industrials at 995.15, Rails at 271.72. Although Rails have established three unconfirmed new highs since, the fact remains that 1966 saw the top of the bull market and 1966 saw the last confirmed highs in the two Averages.



Following February, 1966 the Averages turned down in what was to be the first primary leg of the bear market. That leg ended on October 7 with Industrials at 744.32 and Rails at 184.34. An extended and explosive secondary (upward) correction ensued with Industrials touching a peak of 943.08 (see chart) during 1967 and 985.21 in 1968. Rails during the 1966-1969 period climbed to successive all-time highs of 274.49, 279.48 and 279.88.

In recent Letters I noted that the time element for the 1966-1969 secondary upward retracement was drawing to a close, that the longer the upward movement continued contra to the primary bear trend, the nearer the danger point for this market. Last February 7 marked the third anniversary for the bear market, and that day saw Industrials a mere 40 points below their

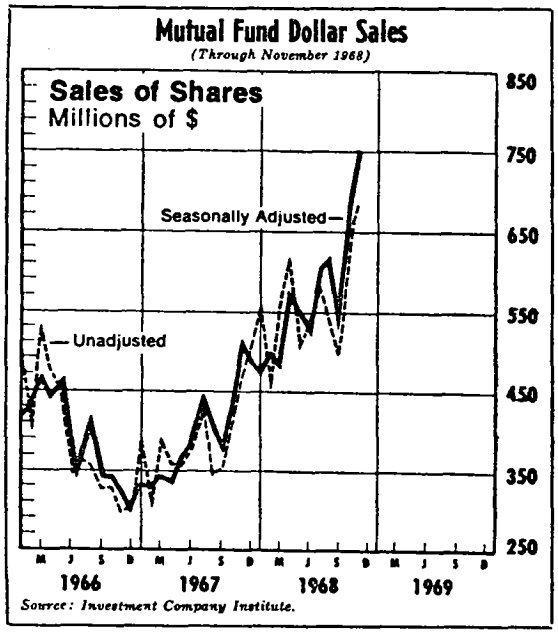
1966 high. As a rule, the longer the market moves against the primary direction, the more extended and violent will be the ultimate resumption of the market action in the direction of the prevailing primary trend.

On December 3, 1968, the Dow Industrials touched their post-1966 recovery high at 985.21. On February 7, 1969, the Rails hit their post-1966 peak at 279.88. I noted in the last Letter that far from being a hopeful sign (and here I differed sharply with almost all other commentators), I saw the new unconfirmed Rail high as a signal that the stock market was on more dangerous ground than ever. I pointed out that the time element for the belated Rail high was not favorable, and I also noted that both the A-D ratio and the 20-day average of the A-D ratio (see special study in last Letter) were unfavorable.

Following the February 7 Rail high of 279.88 Industrials pushed up laboriously to a peak of 952.45 (February 13). Rails were diverging at the time (moving down against Industrials). The next day (Monday, February 17) the market sold off violently with Industrials down 14 points, Rails down 4 (which was strange action considering the outstanding recent strength in the carrier action). The extreme weakness continued throughout the week.

It would be "easy" now to announce that the 1966-1969 bear market recovery has finally fallen apart. Neither I nor any man alive can know or be sure of such an event. "Quackery," wrote Robert Rhea in 1934, "can usually be detected by positiveness of pronouncements. Those who have attained a bachelor's degree are never so cocksure."

Personally, I would guess that the contra-primary forces have now about given up the ghost. I believe that from the standpoint of both duration and upward extent, the corrective rise which began in October, 1966 is on dangerously thin ice. I feel that the three non-confirmations on the upside produced by the Rail Average constitute a dangerous situation. The short interest ratio for the thirty Dow Industrials has been shouting a warning, and this was covered extensively in the last Letter. On a shorter term basis, the 20-day average of the advance-decline ratio showed that the upward movement in the main body of stocks on the N.Y.S.E. ended around mid-January. On February 18 the A-D ratio plunged below its January 13 low, thus dropping to a new low for 1969. This meant that on February 18, the majority of stocks on the N.Y.S.E. were showing a loss on balance for 1969, hardly a favorable development. Actually, the late-February plunge in the A-D ratio took that indicator to its lowest level since September, 1968. At that time the Dow was under 900, which means that if the Dow is to confirm the weakness in the A-D ratio it is headed well under the 900 level.



A number of particularly ominous factors must now be considered. First, the mutual funds have been very heavy operators in this market, and as seen on the accompanying chart, purchases of fund shares by the public since 1966 have been almost unbelievable. Second, new margin accounts are now huge with 940 thousand having been opened in the period through August, 1968, as against 770 thousand in the corresponding 1967 period. Total margin debt is now $6.3 billion, as against $5.6 billion the year before. Speculation has been very heavy in the markets, with the public and the funds running up many secondary and speculative issues to totally unreasonable heights. Finally, doubt has been cast on many of the new corporate "put-to-gethers" such as the conglomerates, and new legislation may be produced to stop their wild expansion.

To me, a paramount consideration (aside from the crucial consideration of the direction of the primary trend) is whether any extended or sharp downward movement from here will be able to knock bricks out of the credit edifice. This generation has never seen a giant speculative structure come apart at the seams, it has never experienced mass margin calls, forced selling, extended credit distress and financial panic. Many have an unfounded (or untested) faith in "the Government" to stop a decline or to save a crashing market. Perhaps the Government can turn a primary bear market around, but it has never done it yet. To be fair, the Government has not been put to the test since 1929 and 1937, at which time it failed.

Furthermore, we now have the added problem of what the Administration will actually do if this market starts falling out of bed. Mr. Nixon and his team are openly committed to stopping inflation, and no one knows whether they will

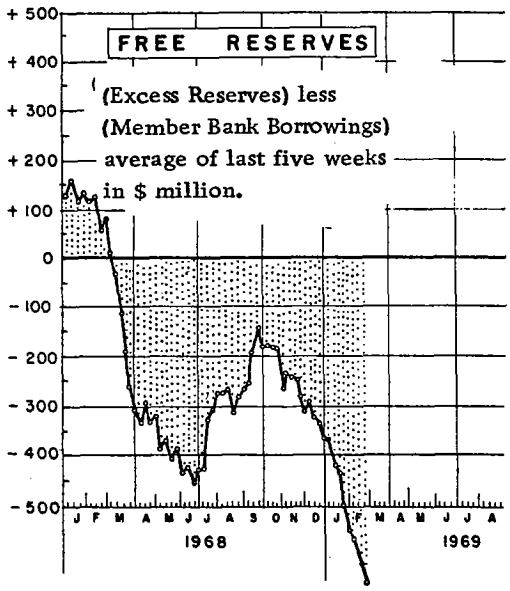
really take a market decline very seriously at this point. Ironically, the last major market decline occurred in 1962, and at that time the market's cave-in effected business hardly at all. Mr. Nixon may well take the position that the market is in a universe of its own, and that if a Wall Street smash helps him to hold back inflation, so be it.

My own feeling is that if the market collapses, the Government may shortly have reason to rue the event. The history of 1929 to 1932 and 1937 to 1942 suggests that the Government has been singularly unsuccessful at turning around an economy which is in the grips of a primary bear trend. True, the Government can stimulate or over-stimulate a bull market, or even temporarily hold back the bull forces, but in the long run history indicates that primary forces are a law unto themselves, and that no Government, Congress or agency has ever been able to keep the primary trend from ultimately expressing itself.

In proof I will repeat that the period from 1966 to 1969 has had almost no parallels in terms of Governmental inflationary policies. When we consider what the Government has done during those three years, why did the Dow Industrials not go to 1000 or even 1500? The answer is that the primary bear trend was ever lurking in the background, exerting its invisible force on the 30 stocks which represent many of the largest and most important corporate entities in the world.

Conclusion: Subscribers should fully expect the primary bear forces to express themselves. It is merely a question of when. I know that the main downward primary movement is overdue to resume. It could be starting now. Subscribers should be extremely cautious at this time. They should be highly liquid with positions of perhaps 70% to 85% in 91-day Treasury bills and hedge positions in gold shares. That's the way I see it.

DEFLATION: Suddenly, all the "experts" are starting to take the possibility of deflation seriously. Suddenly, the market has begun to take deflation seriously. The market takes deflation seriously by acting—it deflates itself. The experts do what they usually do—they talk and expound and explain why their last vision now has to be revised.



A few weeks ago Paul McCracken, Chairman of the Council of Economic Advisers, stated, "The Government's intention to pursue a moderate and gradual course of cooling the inflation is clear." His statement was after the fact. To my mind, the Government's real anti-inflation policy started last December 17 with the boost in the discount rate. Next (see chart, courtesy of Merrill Analysis, Box 228, Chappaqua, N.Y. 10514), came a massive squeeze on comercial bank reserves, which by last week reached minus or borrowed reserves of $721 million. As the authoritative Weekly Bond Buyer (Feb. 17) put it, "The classic pattern.....in a credit-tightening operation is for the medium-size banks to be squeezed first, while the money market banks remain easy; then the medium-sized banks are squeezed even tighter and the money market banks turn neutral; and finally all banks are tight." They continued, "While one week's statistics are not enough to depend on, they are sometimes enough to give heart, and New York last week was tight!"

All of this is not without its effect. On the face of it, manufacturers are going merrily along with expansion plans and new orders for durable goods. But the black cloud, that tiny black cloud, is forming. The cloud is the consumer, who is now beginning to cool it. As the Wall Street Journal stated last Friday (Feb. 21), "In contrast to the strong showing at the factory level, the Commerce Dept. reported that retail sales have lost much of their steam lately and are running only narrowly ahead of the year-earlier level." According to the astute Argus Research people, "In terms of unit volume, after adjusting out the effects of rising prices, we estimate that January sales were the lowest since last April, except for December."

The Commerce Dept. now fears an inventory pile-up with manufacturers continuing to stock up while consumers continue to turn bearish. I concur, and I believe that we are going into this type of so-called "involuntary" inventory build-up now. When that happens, it means that manufacturers have bought against a tomorrow that "ain't going to be," and the ultimate result is a sharp contraction in factory orders and distress selling by those manufacturers who are forced to reduce inventories to raise cash. I believe that all this lies ahead.

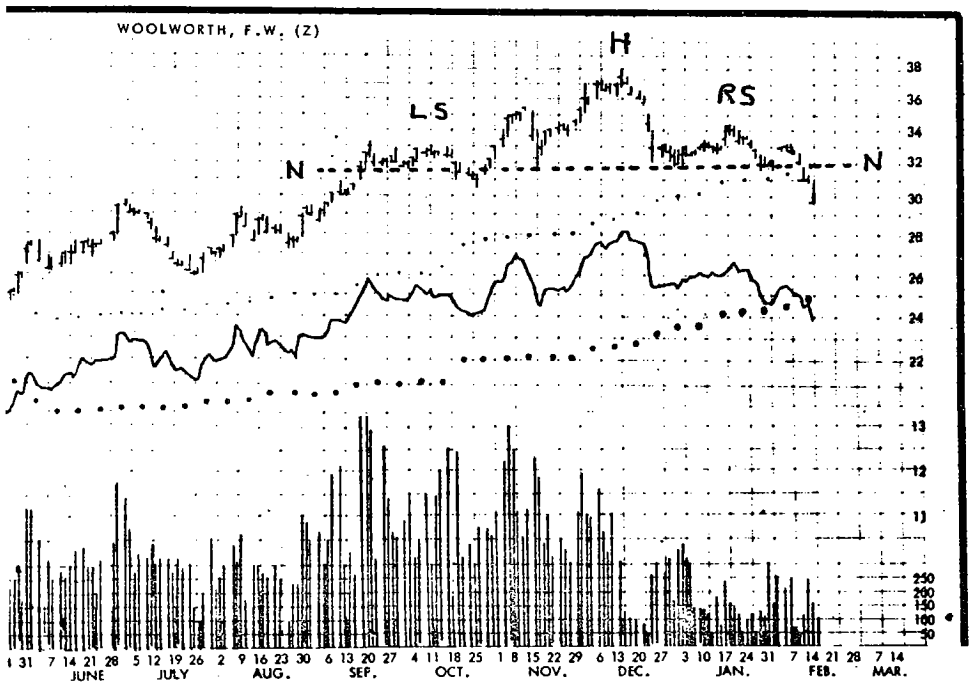
The pressure to reduce inventories and get liquid is doubly intense when money rates are up in the stratosphere. The nation's experts have now faced up to the possibility that a money and interest rate crunch is not "coming," it is here. Speaking before the National Industrial Conference Board last week, the Chief Economist for Bank of America, Walter Hoadley said that corporate financial demands are "almost insatiable," and he added, "In 1969, and beyond, the corporate financial officer will have to be concerned not only with the cost of funds but with the problems of chronic unavailability."

It appears to me that most of the "people in the know" are counting on a mild economic slowdown to ease up interest rates and "put everything back to normal." I continue to warn against this simple, classic approach. That type of thinking applied years ago when the national debt load was much, much lighter. With Vietnam, with dozens of built-in and mounting Government expenses, the needs of our Government are almost insatiable. The debts of the state and local governments, which were $15 billion twenty years ago, amount to $120 billion today — and they continue to rocket. To me, the big question is, what happens if business and individual income drops off sharply — against a background of mountainous debt and huge expenses? At that time, as tax receipts to the Government decline, the Treasury will be forced to come into the money market in an unprecedented way. Uncle Sam is going to take on all bidders in a frantic search for money, and the results could well be interest rates going through all ceilings — to highs undreamed of by this or any other generation.

Each bull market breeds the seeds of its own destruction. The flowers of evil for this generation are debts, over-speculation against those debts, and over-optimism that the interest on those debts can be serviced perpetually.

The one thing which all the economists are leaving out or over-looking is the totally unexpected — possible stock market collapse and an accompanying cave-in in consumer confidence. If that happens, you can throw all the experts' opinions to the winds. Under Dow Theory this is a bear market, and we have had an extended and totally abnormal two-and-one-half year bear market rally. Such action allows for a collapse at any time. That is what the experts in Washington and in corporate offices have not taken into consideration. I have never forgotten it for a moment. Anyone who has spent a lifetime studying Dow's Theory and the history of economic booms and busts couldn't forget it.

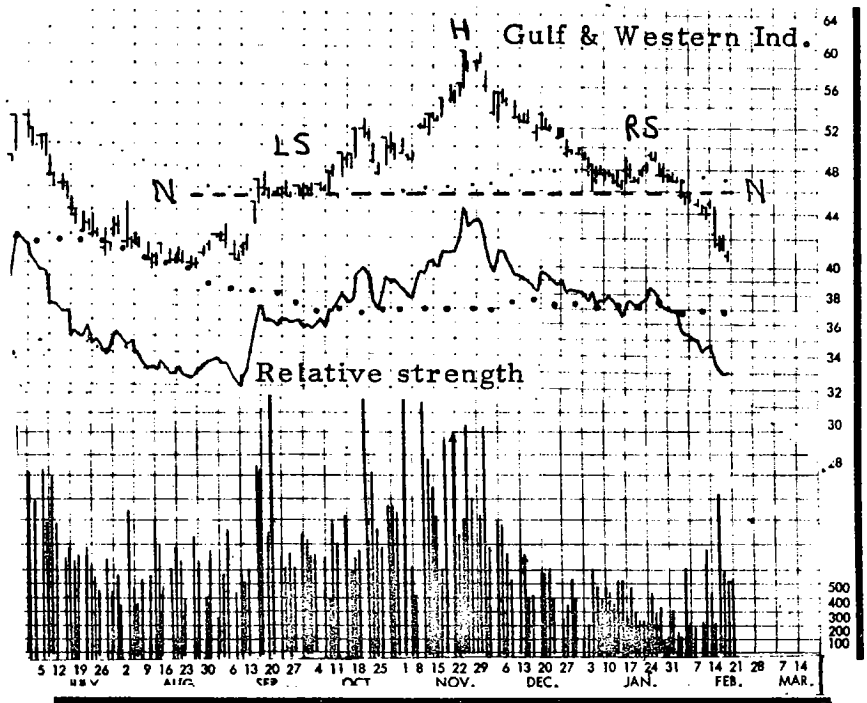
THE MARKET: Study a chart book such as the Traders Research publication (101 Cherry St., Alton, Ill. 62002) or the Quote Digest (110 N. Lorrain, Wichita, Kans.) and you will see a textbook of top formations. Hundreds of individual stocks are now forming tops, have completed tops or are actually breaking down.



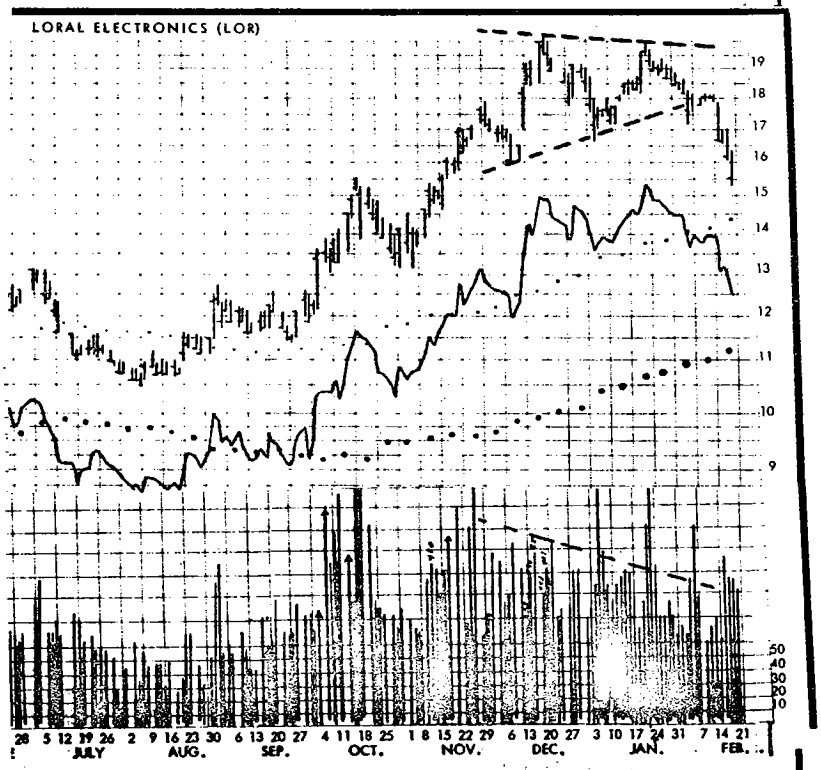
I include four charts from this week's Traders Research chart album, and I feel it is important to study these rather representative patterns. Note that Woolworth has formed a complex "head-and-shoulders" top. Heavy volume came in on the left shoulder (LS on chart), but on the rally to the head (H) volume petered out ominously. The price then broke back to the neckline (N), and the final rally to the right shoulder (RS) brought in very little volume. Woolworth

gapped up mysteriously and ominously just as RS was being completed. Last week Woolworth plunged through the neckline at N and the top was completed.

The second chart shows the rather weird head-and-shoulders top in Gulf & Western. Once again the important volume implications must be studied. On the run-up to the head at H, volume suddenly dropped off. On the final rally to RS, volume almost disappeared. The penetration through the neckline at N developed good volume again, and the stock was on its way down. By last week Gulf & Western was back at last August's levels.



The third chart shows the symmetrical triangle in Loral Electronics. In this type of small, symmetrical triangle a good deal of force is often generated. When Loral fell out of the lower up-slanting trendline the stock broke sharply, so sharply that some sort of a rally can probably now be expected.



Dome Mines, on the other hand, had formed what also seemed to be a rather toppy pattern. Then, a week ago, the pattern reversed on big volume, and Dome rocketed to 81¼, just a point from its all-time high. Heavy volume on the upside tended to validate the movement. The big upside gap in the Dome rally is rather unusual, and it indicates considerable force in the buying. The latest rally in Dome may be premature in that the other major gold stocks have not followed. On the other hand, they have rallied some, and the whole gold advance may be anticipating something from Mr. Nixon regarding gold as he trots about Europe, preparatory to facing Mr. DeGaulle and the Russians.